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40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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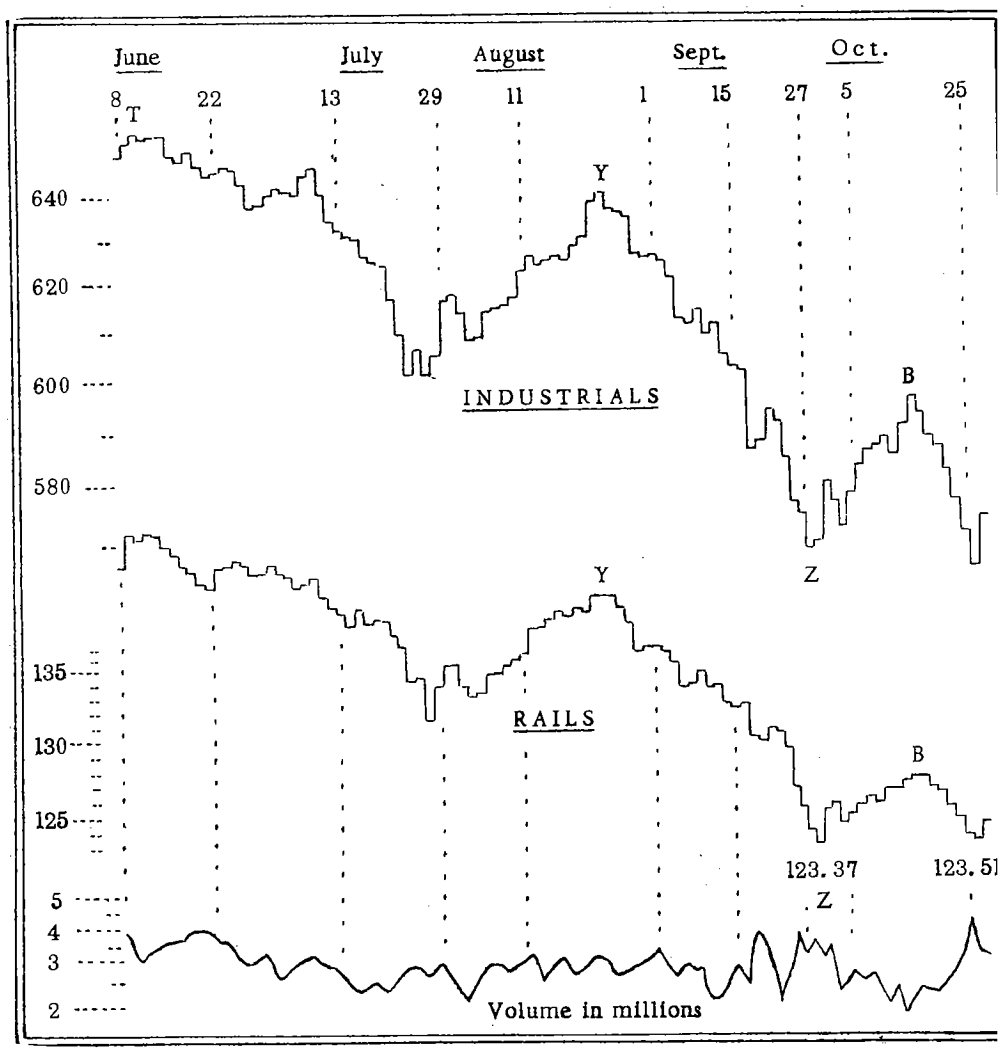
THE MARKET. The rally which began at Z (see chart) advanced Industrials 27.40 points, Rails a mere 4.25. The rise lasted a total of twelve trading days. I am classifying the Z-B movement as a rally within the third broad downward swing (or primary) leg of this bear market. My reasons for classifying Z-B as a rally and not a full secondary correction of the T-Z leg are as follows: (1) the Z-B movement was quite brief (secondaries usually last three weeks to as many months), (2) the Z-B Rail rise was subnormal, (3) the structure of the Z-B movement was extremely simple (whereas most secondary reactions consist of at least one well-defined zig-zag).

In Letter 120 I presented a detailed description of the June and August, 1960, peaks, and I noted that the danger signs which appeared at those tops might show themselves repeatedly during this bear market. As things worked out, the recent B peak proved to be almost a carbon copy of the August (Y) top. Rails formed another tiny three-day "line", Industrials made a final thrust, then both Averages fell away as volume expanded. To make things even simpler, during the week of the rally peak (at B), volume contracted to the lowest level in fourteen months, suggesting, of course, that the advance had not succeeded in gathering a following.



Ever since the violation of the 599.10 Industrial level, the market has been traveling in "primary territory", and volume indications have been considerably easier to interpret. In classic bear market fashion, volume has tended to contract during advances and expand on declines. I put out shorts on October 13 and 14 when it became obvious that the rally was "running out of steam". The upside progress of Rails had been almost pathetic, volume had dried up drastically, and new lows had outnumbered new highs on each of the twelve days of the Z-B rally.

On the sweeping decline from B volume expanded progressively, hitting a high of 4.42 million shares

on October 24. On October 25 (the seventh consecutive day of decline) Industrials violated Z, but Rails refused by 14 cents to confirm (see chart). Volume also contracted to 3 million shares on the Industrial penetration of Z. At this point many Dow Theorists took "insurance" and covered part of their short commitments.

Reversals have often been signalled by the refusal of one Average to confirm the penetration of the other. It is still too early to judge the quality of the rally which began on October 26, but there is the possibility that (1) the Averages will correct 1/3 to 2/3 of the losses sustained since B, or (2) the Averages will jointly better the B points and thus begin a full correction of the entire decline since T.

First hints that the rally was fading could be diminishing upside volume or (if the B points are approached) a refusal of one or both Averages to better B (B -- Industrials 596.48, Rails 127.62). Often an extended bear swing will be punctuated by violent but short-lived "whip-backs" (brought on by sudden spurts of short-covering). Odd-lot short selling has run high of late; there were 10 thousand odd-lot shorts on October 24, 7 thousand on October 25. This alone could be instrumental in touching off a rally. (Note: Garfield Drew, who is an expert on restaurants as well as odd-lots, compares the total daily odd-lot shorts with the total daily odd-lot sales. This gives him a ratio which is much more useful than mere daily odd-lot short totals. On Mr. Drew's ratio basis, odd-lot short selling has not been heavy enough to imply a big upward movement at this time.)

The 599.10 Industrial level was shattered after six months of distribution. The subsequent Z-B Industrial rally expired in the same 596-99 area. It seems to me that the chance of an Industrial rise above the 599 level is now rather slim.

CHANGE In 1899, Dow noted that it often takes a year or so for a broad market change to occur "... because millions of people have to experience in their own fortunes the change of conditions before they are willing to accept them as genuine."

During the better part of the last decade we have been treated to a continual barrage of books, pamphlets and market letters all warning of the dangers of perpetual inflation. History suggests that once a broad and persistent trend is established and once people get used to thinking in harmony with that trend, it is almost impossible to bring them to believe in the possibility of that trend's changing. Thus in the early stages of a new bull market (i.e. 1926, 1933, 1953) any decline is suspect and is generally taken to be a resumption of the previous bear market. As a bull market progresses, however, investors become increasingly indoctrinated with "bull fever". By the time a bull market has reached its third or speculative phase the old "bear market fears" are completely forgotten, and the very idea of a bear market is viewed with disbelief. Declines in the third phase of a bull market are usually seen as "golden opportunities" for making new purchases, and it is about this time that the analysts start writing about the "new era" and "the Government regulations which will prevent a bear market from occurring again."

In viewing the decline of 1959-60, one is struck by the fact that it has (so far) been quite different from the 1929 or 1937 collapses. Stocks in 1959 have gone down quietly, persistently and without margin calls. Yet a recent accounting shows that two-thirds of all common stock listed on the New York Stock Exchange are now well below their highs of the last few years (many have suffered drastic collapses). On October 24, 1960, 233 (over 20%) of the 1100 common stocks on the "Big Board" sank to new 1960 lows. A comparison of the bull market high and current quotations on many leading equities such as Reynolds Metals, Chrysler, Montgomery Ward, Anaconda, Eastern Airlines, New York Central, etc. is quite startling. Less obvious but just as important is the movement of basic commodity prices over the last year. I have reprinted a little item from the October 14 Journal of Commerce which might even give Mr. Kiplinger pause for thought.

J of C Price Index Lowest in Decade

Persistent pressure on prices of primary commodities, particularly in industrial materials, drove the Journal of Commerce Daily Index of Sensitive Spot Commodity Prices to the lowest level since the Spring of 1950.

Led by a further decline in copper prices yesterday, the barometer dropped to 88.9 per cent of its 1947-1949 base.

PRIMARY TREND A subscriber writes, "I have been trying to absorb all the facts that you have thrown at us over the last few months and it hasn't been easy. In your opinion, what is the single most important thing for investors to know at this time?"

In my opinion the most important thing for an investor to know at this or any other time (and the point which I have always stressed) is the direction of the primary trend. Dow, of course, placed utmost emphasis on the correct appraisal of values in conjunction with a knowledge of the primary direction. Thus he states in one of his Wall Street Journal editorials: "The first thing for any operator to consider is the value of the stock in which he proposes to trade. The second is to determine the direction of the main movement of prices."

In these Letters I have attempted to provide frequent appraisals of values as well as continuing discussions regarding the primary trend. Older readers remember that I used such orthodox (and perhaps forgotten) considerations as yield, values, volume, public psychology, phase, movement of the Averages, short interest ratio and breadth in attempting to identify the bull market top of 1959. Many of these same factors will (I hope) help us to identify the bear market bottom when it arrives.

Although I have probably written more about the primary trend than about any other subject, I still have the feeling that most of my readers do not fully understand its significance. The primary trend is the broad tidal movement of the economy and the market. The tide is relentless and all-engulfing; it is immune to manipulation. When the tide turns up it carries almost everything with it; stock prices, commodities, wages, employment, etc. When the tide turns down it generally sweeps all before it.

The great Dow Theorists all possessed a fundamental understanding of the tidal action. For example, on May 25, 1900, Dow wrote: "A bull market extending over three or four years is like a rising tide. It floats up everything that will float, and the flotation is always found to include a great deal that lacks value and consequently lacks salability when the tide begins to recede."

In August, 1901 Dow again wrote: "There is a general similarity in all 'booms' and in all periods of depression. The character of these movements is like a snowball running down an inclined plane and gathering snow as it runs. The movement is slow at the start, becoming quicker as progress is made and usually being quickest of all just before it ends."

On September 8, 1937, Rhea warned: "When the Averages confirm a change of primary trend from bull to bear, neither the duration nor extent of the forthcoming contraction in business and security prices is indicated. All we know is that trouble lies ahead, and that investors, business men, and workers will be adversely affected. No one can escape punishment when the primary trend of the market is downward. Someone owns every share of stock in existence when the sun goes down each day, and the owner's assets are proportionately diminished with each decline, so he, as a consequence, curtails expenditures. Projected residence building and factory expansion are abandoned, unemployment is increased, and these diminish mass purchasing power."

GOLD Campbell Red Lake, Dome Mines, Homestake and the speculative Canadian golds were recommended here (Letters 113, 117) before their recent advances. In my opinion, the gold movement is not a mistake, it is not a technical adjustment, it was not set off by "amateur speculators". Despite the fact that the nation's press has been talking about a "gold bubble", fundamental forces are in motion which suggest the possibility that a "run" on the dollar has started. Not since the bear signal, in fact, have so many sources denied what the market was saying. Thus The New York Times in its editorial (Oct. 25) angrily states: "There is no dollar crisis except in the feverish imaginations of some speculators."

Mr. Kennedy's presidential chances have been improving, and no doubt the market is partially discounting the possibility of his election to office. Mr. Kennedy has noted much that is "wrong" with the country, but his answers to all of the nation's problems seem to boil down to the same solution -- spend more money. While this solution may well be the correct one, I have strong suspicions that it will also be an unfeasible one. The imbalance of international payments under which this country is now laboring together with the probability of more deficit spending is enough to arouse anxiety in the heart of many a foreigner. The result is a flight from dollars and into gold. Fortunately or unfortunately, my job does not entail advising Mr. Kennedy, but it does

entail advising subscribers. My opinion -- do not take the gold movements lightly (better still, hedge by buying a few shares of gold).

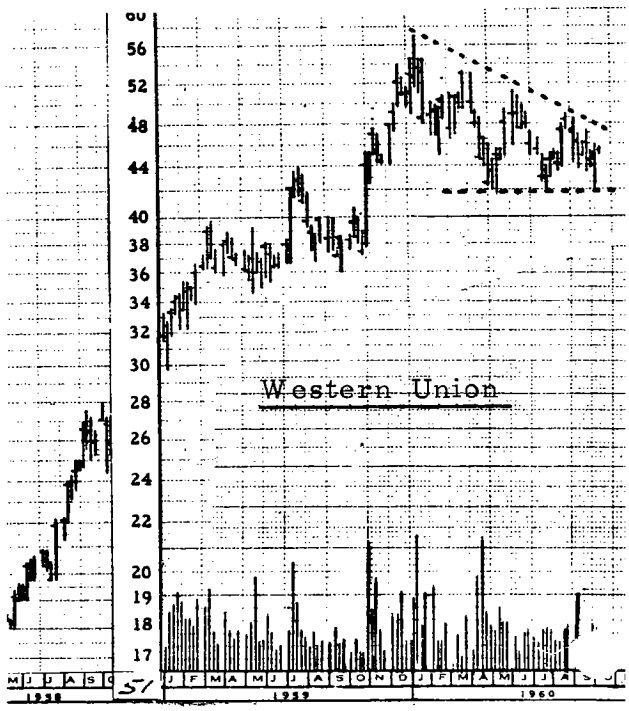
(Gold charts may be purchased from Mr. Iain Fraser, 199 Bay Street, Toronto 1, Canada.)

SUNDRY THOUGHTS If Industrials eventually violate the 548 level, Dow's 50% Principle will come into effect. New subscribers who do not have the recent Special Study on this Principle (or old subscribers who wish another copy) please send a large, stamped, self-addressed envelope.

I would like to thank subscribers who were kind enough to send "get-well" cards and notes. All of them were delivered to me at the hospital and were greatly appreciated.

Most of this Letter was written from a hospital bed, and I wish to apologize for the rather hurried and in many instances disjointed writing.

STOCKS I cannot tell subscribers when to cover shorts, the more so if they have quick profits on the short side. I usually hedge by taking half of any quick profit, while letting the other half run. Western Union has formed a great descending triangle with a base at 42. It appears to be a short sale at the market.



Charts courtesy of Traders Research Inc., P.O. Box 6185, Lambert Airport, Mo.

(Written Thursday, October 27th - 2 P.M.)

DOME MINES LTD. (gold) -- Daily price movements and volume. Note the double "testing" of the 17 area at A and C. Note also the extreme contraction of volume on the second test at C. In August DM hurdled its May peak of 19 (B) to the accompaniment of heavy volume, then formed the triangle at D. From D a little consolidation "flag" was formed (E), and when this bullish formation was broken DM "gapped" upward on tremendous volume (October). Another triangle was formed at F. The "breakout" of the F triangle came last week as volume again surged. The pattern of DM is extremely bullish, although the stock probably needs a "rest". Downside support should probably come at 23 (at the apex of the F triangle). I contine to believe that DM is a buy (try to get it in the 23-26 area).